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In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 932

TRUST U/W OF MARY LILY (FLAGLER) BINGHAM, MESSRS. WILLIAM R. KENAN, JR., AND LAWRENCE C. HAINES, TRUSTEES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The majority (R. 36–49), concurring (R. 49), and dissenting (R. 49–53) opinions in the Tax Court are reported in 2 T. C. 853. The opinion of the Circuit Court of Appeals (R. 55–59) is reported in 145 F. 2d 568.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 27, 1944 (R. 59). The petition for a writ of certiorari was filed on Feb-

ruary 9, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether certain legal fees and expenses paid by trustees are deductible as "non-trade or non-business expenses" within the meaning of Section 23 (a) (2) of the Internal Revenue Code, as added by Section 121 of the Revenue Act of 1942.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes, regulations and committee reports involved are set out in the Appendix, *infra,* pp. 12–24.

STATEMENT

The Tax Court found the following facts (R. 36–41):

At all times since prior to January 1, 1940, the taxpayers were the duly qualified and acting trustees of a trust created by the will of Mary Lily (Flagler) Bingham. Their principal office was in New York, New York. They filed their income tax return for the taxable year with the Collector of Internal Revenue for the Second District of New York. Their books and accounts have always been kept on a cash basis and the income tax return filed by them for the taxable year, 1940, was filed on the same basis. (R. 36–37.)

Mary Lily (Flagler) Bingham died on July 27, 1917. By her will, which was dated September

23, 1916, and duly probated in August, 1917, she appointed two individuals as executors and trustees and, after making a certain devise of real estate and certain specific bequests of jewelry, provided for the conveyance to the trustees of all the residue of the property, real and personal, of which she should die seized and possessed. The will provided for the payment by the trustees to various parties of at least $536,000 in cash legacies and for the delivery by the trustees to various other parties of 40,250 shares of Standard Oil Company stock. All of these beneficiaries were to receive their legacies as soon as compatible with the due administration of the estate and the carrying out of the testator's wishes with reference to the hotel and railroad properties mentioned in item ninth of the will hereinafter set out. The will further provided for the payment of $200,000 annually to a niece of the testator until that niece attained the age of forty years, when she was to be paid the lump sum of $5,000,000, if compatible with the interest of the estate as determined by the trustees. The will also provided that the trustees should pay $75,000 annually to the University of North Carolina during the continuance of the trust and at the expira on thereof should pay to the university such a sum in cash as would produce an annual income of $75,000. (R. 37–38.)

Item ninth of the will provided as follows (R. 38–39):

All the rest and residue of my estate including all lapsed bequests or devises, shall be held for the term of twenty-one years from the date of this will by my said Trustees in trust for the maintenance and administration and development of the Florida East Coast Railway and the Florida East Coast Hotel properties (which are hereinafter called "Principal properties") and the properties held by subsidiary Companies. And to that end, my said Trustees shall have power to sell any of my said residue estate, except the stocks and bonds of said "principal properties," to invest the proceeds of such sales and the income and increments of all my said residue estate in such securities or other properties as they may think best; to use any of the said proceeds or said income or increments for the benefit of any of said principal or subsidiary properties; to make and execute any and all obligations, and all pledges and mortgages of any of my said residue estate except the stocks and bonds of the said principal properties, which may be necessary for the purposes of the maintenance, administration or development of the said principal or subsidiary properties; to exchange any of said properties, other than the principal properties and the stocks and bonds thereof, for any property which to them may seem desirable to be acquired for the benefit of the said principal or subsidiary properties, and continuingly to invest, sell and reinvest at

such times and in such manner and in such sums and in such properties as may seem to them desirable for the purpose of carrying out the maintenance, administration and development of the said properties the primary purpose of this trust being the keeping together of the enterprise into which my beloved husband, Henry M. Flagler, put so much of his energy, ambition and life.

The will further provided that each of the trustees should receive compensation at the rate of $50,000 a year for services as trustee and such compensation also should cover all services which each trustee might render as executor (R. 39).

At the end of twenty-one years from the date of the will the trustees were to divide the property then in their hands into three equal parts and transfer such parts to the testator's two sisters and brother in equal shares (R. 39).

The Commissioner's determination of a deficiency resulted from the disallowance of $210,741.93 expenses paid by taxpayers in the taxable year and deducted by them from gross income in their income-tax return for that year. The Commissioner's reason for the disallowance of these expenses was that they were not ordinary and necessary expenses incurred in carrying on a trade or business within the meaning of Section 23 (a) of the Internal Revenue Code. By stipulation the parties have agreed that all of the expenses originally disallowed by the Commissioner

were ordinary and necessary expenses paid during the taxable year for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, save one item of $25,867.31 paid for legal fees and charges (R. 39–40). The expenses so agreed upon are as follows (R. 40):

Compensation of trustees	$141,369.86
Office salaries	34,934.30
Office supplies and expenses	2,448.97
Petty cash expenditures	1,722.89
Office rent (net)	3,419.10
Tax and financial services	498.75
Miscellaneous expenses	480.75
Total	184,874.62

Of the legal fees and charges of $25,867.31 paid by the taxpayers, $16,439.96 was incurred for services rendered from August, 1937, to January, 1940, in contesting a deficiency of $365,687.12 in income tax asserted against the taxpayers for the year 1935. This deficiency was asserted by reason of the inclusion by the Commissioner in income of alleged gains of $1,991,316.75 resulting from the partial payment in securities of a bequest to Louise Clisby Wise of $5,000,000 under the above-mentioned will. The payment was made in 1935 under the provision of the will that when Louise Clisby Wise reached the age of forty, or as soon thereafter as was compatible with the interests of the estate, she was to be paid the sum of $5,000,000. When Louise Clisby Wise became forty years of age, the trustees paid her $5,000,000 partly in cash and partly in securities.

Some of the securities had been purchased by the trustees and some had been received by the trustees as part of the estate of the decedent at her death, which latter securities had appreciated in value during the period held by the trustees. The Commissioner determined that, to the extent that the value of the securities purchased exceeded their cost and to the extent of the appreciation of the other securities, the distribution thereof resulted in capital gains taxable as specified in Section 117 of the Revenue Act of 1934. In the case of *Kenan* v. *Commissioner*, 40 B. T. A. 824, the Commissioner's determination was sustained, and in 114 F. 2d 217 (C. C. A. 2d), the decision was affirmed upon appeal. The legal fees here in dispute were paid for services rendered by attorneys in connection with the proceedings there involved. Payments to the attorneys also covered reimbursements for expenses incurred by them in contesting the deficiency. (R. 40–41.)

Of the legal fees and charges paid by the taxpayers, the amount of $780.85 was for services in connection with the payment of the above-mentioned legacy to the University of North Carolina and for stenographic expense incurred by the attorneys in connection with those services (R. 41).

The remaining $8,646.50 of the total of $25,867.31 in legal fees and charges paid by the tax-

payers in 1940 was for services rendered in respect of the tax and other problems resulting from the expiration of the trust and delivery of its assets to the legatees (R. 41).

The Tax Court allowed the disputed deduction (R. 47–49), but the Circuit Court of Appeals reversed (R. 59).

ARGUMENT

The Circuit Court of Appeals, reversing the decision of the Tax Court, held, correctly we submit, that the amount in controversy was not allowable as a deduction in computing the income tax of the trustees under Section 23 (a) (2) of the Internal Revenue Code, as amended (Appendix, *infra*, p. 12), either as "ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income." In so holding, the court took the view (R. 57–58) that expenses which are incurred in connection with the distribution of property to legatees do not come within the scope of the statute. The Circuit Court of Appeals also stressed the point that some of the expenses in question were made to contest income taxes assessed against the trustees, and followed its own prior decision in *Stoddard* v. *Commissioner*, 141 F. 2d 76, holding that such payments were not deductible under Section 23 (a) (2). In that case,

the court pointed out (pp. 79–80) that to extend the language of the statute to make it possible for taxpayers to deduct the expense of litigation over the amount of their income taxes would be too great a stretch in the absence of anything to indicate that Congress intended to so encourage such litigation. Other courts have reached a similar conclusion. *Higgins* v. *Commissioner,* 143 F. 2d 654 (C. C. A. 1st); *Hord* v. *Commissioner,* 143 F. 2d 73 (C. C. A. 6th).

The decision of the Circuit Court of Appeals is in harmony with the Treasury Regulations (Treasury Regulations 103, Secs. 19.23 (a)–15, 19.24–2; Appendix, *infra,* pp. 12–17, which were drawn with the intention of preserving the distinction between ordinary and necessary expenses of collecting or producing income on the one hand and capital expenditures on the other hand. Expenditures incurred in distributing assets to beneficiaries have long been treated as capital expenditures under the regulations. Sec. 19.24–2, Treasury Regulations 103, Internal Revenue Code; Art. 24–2, Treasury Regulations 101, 1938 Act; Art. 24–2, Treasury Regulations 94, 1936 Act; Art. 24–2, Treasury Regulations 86, 1934 Act; Art. 282, Treasury Regulations 77, 1932 Act; Art. 282, Treasury Regulations 74, 1928 Act; Art. 292, Treasury Regulations 69, 1926 Act. And the courts have uniformly held that capital expenditures are not deductible under the statute.

Bowers v. *Lumpkin*, 140 F. 2d 927 (C. C. A. 4th), certiorari denied, 322 U. S. 755; *Helvering* v. *Stormfeltz*, 142 F. 2d 982 (C. C. A. 8th). The regulations also support the view that the expenses of contesting income taxes are not deductible in the circumstances of this case. See Sec. 19.23 (a)–15, Treasury Regulations 103.

In support of their application for certiorari, the taxpayers contend that under *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231, the Circuit Court of Appeals was without authority to review the decision of the Tax Court. But we do not understand that the authority of the court below is so limited. The Tax Court's decision is contrary to the Treasury Regulations. Whatever may be the ramifications of the *Dobson* rule, as exemplified in other cases, such as *Commissioner* v. *Heininger*, 320 U. S. 467; *McDonald* v. *Commissioner*, 323 U. S. 57; *Commissioner* v. *Scottish American Investment Co.*, 323 U. S. 119; and *Commissioner* v. *Smith*, decided February 26, 1945, No. 371, this Term, we do not understand that the circuit courts of appeals are precluded from giving effect to the regulations in determining the scope of this deduction statute which, of course, must be strictly construed (see *Equitable Society* v. *Commissioner*, 321 U. S. 560, 564). We submit that in circumstances such as those here presented, where there is no dispute as to the underlying facts and the question is whether they fit the pattern of the statute as interpreted by the

regulations, the Circuit Court of Appeals properly sustained the Commission's determination. Cf. *Helvering* v. *Stormfeltz*, 142 F. 2d 982, 985 (C. C. A. 8th). The taxpayers also urge (Br. 16–18) that the relevant committee reports show that the deduction should be allowed. But clearly this is not so. The Committee reports, H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 46, 74–76; S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 87–88 (Appendix, *infra*, pp. 17–24), reflect views which are wholly consistent with the regulations. Thus the House report states (p. 75):

> Expenses incurred by an administrator or executor in the administration of the estate of a decedent * * * in adjusting claims against the estate, or in distributing the remaining assets to the beneficiaries, are not deductible under this section.

CONCLUSION

The decision is correct; there is no conflict; the petition should be denied.

Respectfully submitted.

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MARCH 1945.

APPENDIX

Revenue Act of 1942, c. 619, 56 Stat. 798:

SEC. 121, NON-TRADE OR NON-BUSINESS DEDUCTIONS.

(a) *Deduction for Expenses.*—Section 23 (a) (relating to deduction for expenses) is amended to read as follows:

"(a) *Expenses.*—

* * * * *

"(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

* * * * *

(d) *Taxable Years to which Amendments Applicable.*—The amendments made by this section shall be applicable to taxable years beginning after December 31, 1938.

* * * * *

(26 U. S. C. (Supp. III) 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (a)–15 (as inserted by T. D. 5196, 1942–2 Cum. Bull. 96, 97–100, and amended by T. D. 5280, 1943 Cum. Bull. 1022, and T. D. 5331, 1944–4 Int. Rev. Bull. 4). *Nontrade or Nonbusiness Expenses.*—(a) *In general.*—Subject to the qualifications and limitations in Chapter 1 and particularly in section 24, as amended, an ex-

pense may be deducted under section 23 (a) (2) only upon the condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

The term "income" for the purpose of section 23 (a) (2) comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. * * * Expenses incurred in managing, conserving, or maintaining property held for investment may be deductible under this provision even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto. * * *

Expenses, to be deductible under section 23 (a) (2), must be "ordinary and necessary," which presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(b) Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. * * *.

Capital expenditures, * * * are not allowable as nontrade or nonbusiness expenses. * * *

* * * * * *

Expenditures incurred by an administrator or executor in securing the processes and orders of the court having jurisdiction over the probate of the estate, or in collecting the assets of the estate (other than income which, if and when realized, must be reported by the estate for income tax purposes), or in adjusting claims against the decedent, or in distributing the remaining assets to the beneficiaries, or in conserving the assets for ultimate distribution to the parties entitled thereto, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or executor for the production or collection of income which, if and when realized, must be reported by the estate for income-tax purposes, such as fees for collecting rents on property in the estate of the decedent, or for collecting interest or dividends on securities in that estate, or which are paid or incurred during the taxable year for the management, conservation, or maintenance of property in the estate of the decedent held for the production of income, the income from which, if and when realized, must be reported by the estate for income tax purposes, such as ex-

penditures for insurance or repairs, or expenditures of a similar nature, are deductible under this section at the option of the taxpayer notwithstanding that deductions therefor are allowable under section 812 (b) in computing the gross estate subject to the estate tax, provided the requisite statement and waiver are filed. (See section 162 (c).)

* * * * *

Reasonable amounts paid or incurred by a trustee on account of trustees' fees and other expenses which are ordinary and necessary in connection with the production or collection of trust income or with the management, conservation, or maintenance of trust property held for the production of income are deductible, notwithstanding that the trust is not engaged in a trade or business.

* * * * *

It is immaterial whether the expenses of fiduciaries are paid from the corpus of the estate or from income. Expenses derive their character not from the fund from which they are paid, but from the purposes for which they are incurred.

Expenditures incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered

in collecting such rents. Expenditures incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible expenses. Expenditures incurred for the purpose of preparing tax returns (except to the extent such returns relate to taxes on property held for the production of income), for the purpose of recovering taxes (other than recoveries required to be included in income), or for the purpose of resisting a proposed additional assessment of taxes (other than taxes on property held for the production of income) are not deductible expenses under this section, except that part thereof which the taxpayer clearly shows to be properly allocable to the recovery of interest required to be included in income.

The deduction of an item otherwise allowable under section 23 (a) (2) will not be disallowed simply because the taxpayer also had an election under chapter 1 to treat it as a capital expenditure, rather than to deduct it as an expense. (See section 24 (a) (7), added by section 130 (a) of the Revenue Act of 1942.) Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in chapter 1, no deduction is allowable under this section; and this is true regardless of whether any basis adjustment is allowed under section 113.

(c) The provisions of section 23 (a) (2) are not intended in any way to disallow expenses which would otherwise be allowable under section 23 (a) (1) or the regulations applicable thereto, or under any other section of the Internal Revenue Code

or the regulations applicable thereto. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code can not again be deducted under any other provision thereof.

SEC. 19.24–2 (as amended by T. D. 5166, 1942–2 Cum. Bull. 87). *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23 (l).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. * * *

H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 46, 74–76:

6. NONTRADE OR NONBUSINESS DEDUCTIONS

The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to

the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayers' trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable.

SECTION 118. NONTRADE OR NONBUSINESS DEDUCTIONS

This amendment allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property

held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23 (a) (2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term "income" for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no liklihood that the property will be sold at a profit or will otherwise be productive of income. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses, to be deductible under section 23 (a) (2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is sub-

ject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. Section 24 (a) (5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23 (a) (2) or otherwise, which is allocable to one or more cases of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23 (a) (2) for amounts allowable under that section which are allocable to tax-exempt interest.

Expenses incurred by an administrator or executor in the administration of the estate of a decedent, such, for example, as expenses in securing the processes and orders of the court having jurisdiction over the probate of an estate, or in adjusting claims against the estate, or in distributing the remaining assets to the beneficiaries, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or an executor for the production or collection of income which must be reported by the estate for income tax purposes, may be claimed as deductions under this section notwithstanding that deductions therefor are allowable under section 812 (b) in computing the gross estate subject to the estate tax. Accordingly, subsection (c) of this section amends section 162 to provide that no deduction shall be allowed under section 23 (a) (2) in computing the net

income of the estate for amounts for which there may have been or has already been allowed a deduction under section 812 (b) in computing the net estate of the decedent. The present amendment would not allow as a deduction under section 23 (a) (2) for income tax purposes any amount which is allowable under section 812 (b) as a deduction in computing the net estate of a decedent for estate tax purposes, unless the Commissioner receives a statement, filed within the time and in the manner and form prescribed by him, to the effect that the amount in question has not been claimed or allowed as a deduction under section 812 (b) and that the right to have such items allowed at any time as a deduction under section 812 (b) is waived.

Subsection (d) of this section amends section 23 (l) of the Internal Revenue Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Internal Revenue Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior revenue act on the date of its enactment.

S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 87–88:

SECTION 121. NON-TRADE OR NON-BUSINESS DEDUCTIONS.

This section is the same as section 118 of the House bill, except that subsection (c) of that section has been omitted therefrom and now appears as section 163 and a clerical amendment has been made in subsection (b). The amendment made by this section allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23 (a) (2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term "income" for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable

year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income, and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as non-trade or non-business expenses.

Expenses to be deductible under section 23 (a) (2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. Section 24 (a) (5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23 (a) (2) or otherwise, which is allocable to one or

more classes of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23 (a) (2) for amounts allowable under that section which are allocable to tax-exempt interest.

Subsection (c) of this section amends section 23 (l) of the Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear, and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior revenue act on the date of its enactment.

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